COMPLIANCE CORNER

Compliance Challenges in the Age of Crypto

By Keri E. Riemer, Of Counsel, and Rich Kerr, Partner, K&L Gates LLP*

While the SEC and its staff have long indicated that they are focused on advisers' investment of client assets in cryptocurrencies and other digital assets (crypto assets), this attention seems to have been elevated in the last several months, presenting heightened risks for advisers engaging – or considering engaging – in such activity.

For example, SEC Chair **Gary Gensler** stated his belief that "the vast majority [of tokens in the crypto market] are securities" as recently as September 8.[i] This pronouncement followed other SEC actions, including the SEC announcing in May that it was doubling the size of its staff responsible for protecting investors in cryptocurrency markets, and the SEC declaring in a complaint filed in July that nine crypto assets were "securities."[ii] In light of these actions, investment advisers that are currently, or are considering, providing advice to clients about investments in crypto assets must consider the unique aspects of such investments and the compliance challenges they present.[iii] We highlight below some particular concerns advisers may wish to consider when evaluating their compliance obligations under federal securities laws, rules, and regulations as they relate to crypto assets.

Keri E. Riemer

Rich Kerr

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Custody

Rule 206(4)-2 under the Advisers Act (the **Custody Rule**) provides that an investment adviser has "custody" of client assets if it holds, directly or indirectly, client "funds" or "securities" or has any authority to obtain possession of them. An adviser may gain custody of client assets inadvertently, such as by being authorized by a custodial agreement to withdraw client funds or securities (even though the advisory agreement has a contrary provision)[iv] or, in connection with crypto assets, where an adviser has access to a client's private key to a crypto asset. The Custody Rule also provides that it is a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Advisers Act for an adviser to have custody of client funds or securities unless they are maintained in accordance with the Custody Rule's requirements, including the requirement that the assets be held with a "qualified custodian" (*e.g.,* a federally insured bank[v] or an SEC-registered broker-dealer), subject to guidance of the SEC staff.

The Custody Rule was adopted in 1962 with traditional assets in mind and has required periodic revisions and interpretations to address evolving investment vehicles.[vi] Despite these efforts, the unique nature of crypto assets, the reliance on distributed ledger technology, and how the Custody Rule applies in the context of crypto assets remains uncertain. As such, and in light of the SEC's focus on crypto asset-related activities, advisers should consider the following, among other factors, when assessing how to comply with the Custody Rule in the context of crypto assets:

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- In light of the broad reach of the Custody Rule and the many ways in which an adviser may inadvertently gain custody of client assets, an adviser that does not assume that it has custody of all crypto assets held in client accounts should carefully evaluate its authority with respect to such assets. For example, the adviser should consider whether it acts pursuant to a standing letter of instruction or other similar arrangement between a client and its custodian that allows the adviser to disburse funds to one or more third parties specifically designated by the client. In such an instance, the adviser would be viewed as having custody.[vii] It should also carefully review clients' custodian arrangements to determine what powers the adviser may be granted therein.

- While there is an ongoing debate as to whether crypto assets – excluding bitcoin – are securities subject to SEC regulation or commodities subject to regulation by the CFTC (or neither), it is likely that any crypto asset would be considered "funds" or "securities" subject to the Custody Rule. The term "funds" is not defined in the Custody Rule or the Advisers Act. However, the SEC has regarded cash and bank deposits to be "funds," and some crypto assets, such as dollar-backed stablecoins, are similar to those assets with respect to their purpose and functionality. As noted above, Gensler indicated that he believes most crypto assets are securities. Accordingly, it would be prudent for advisers to consider all crypto assets to be funds or securities for purposes of the Custody Rule.

- An adviser that has determined it has custody of its clients' crypto assets and that such assets are funds or securities – or at least has a policy of treating such assets as funds or securities for purposes of the Custody Rule – must hold such assets with a qualified custodian. The SEC has stressed that determining whether an institution is a qualified custodian for purposes of the Custody Rule is a "complicated, and facts and circumstances based, analysis given the critical role qualified custodians play."[viii] It has also cautioned that only those institutions possessing certain characteristics, including being subject to extensive regulation and oversight, may be qualified custodians. As indicated above, a national bank may provide certain cryptocurrency custody services on behalf of customers if the bank has the capacity to do so in a "safe and sound manner." In demonstrating that it can provide such services, the bank should have established "an appropriate risk management and measurement process for the proposed activities, including having adequate systems in place to identify, measure, monitor, and control the risks of its activities, including the ability to do so on an ongoing basis."[ix] Certain trust companies chartered in states where regulators have established frameworks for chartering and supervising digital asset trust companies may be considered qualified custodians for purposes of the Custody Rule. In seeking to identify a qualified custodian, an adviser should consider the security features offered. For example, an adviser may wish to consider whether the bank or trust company provides cold storage (*i.e.,* storage disconnected from the internet, typically in the form of a hardware device or paper wallet) and multisignature wallets (*i.e.,* cryptocurrency wallets that require two or more private keys to sign and send a transaction). In light of the varying characteristics of crypto assets, the adviser should also confirm that the institution will accept, and is equipped to provide the required services for, all types of crypto assets held by the adviser's clients. The adviser should also consider the custodian's processes for trading crypto assets – which could result in compliance gaps – and how such gaps could be addressed.

Valuation

The SEC recently observed that investment advisers may face valuation challenges for crypto assets due to market fragmentation, illiquidity, volatility, and the potential for manipulation.[x] Perhaps due in part to these challenges, the SEC's Division of Examinations is likely to review an adviser's valuation methodologies with respect to any crypto assets held in client accounts. In connection with its valuation policies and procedures for crypto assets, advisers should consider, among other things:

- ***Identifying and monitoring for events that could impact the valuation of crypto assets held in client accounts.*** For example, in the event of a "fork," a cryptocurrency blockchain splits into different paths, potentially resulting in different crypto assets which could have different prices. Similarly, in the event of an "airdrop," a cryptocurrency owner is given free coins in a new currency by a promoter. Advisers should consider whether the crypto assets held in client accounts could be subject to such an event, and if so, whether the adviser's valuation policies and procedures would address it, including whether such events result in increased volatility or dilution in value.

- ***Reviewing the adviser's fair valuation procedures to confirm that they account for crypto assets or modifying such procedures if necessary.*** Since in many cases the crypto assets may need to be fair valued, advisers should consider whether their procedures provide for such valuation. Moreover, prior to providing advice with respect to a specific crypto asset, advisers should consider whether appropriate means of

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obtaining inputs to the valuation process are available.

Due Diligence and Monitoring Regulatory Activity

As noted above, the SEC and its staff have indicated – directly through public statements and indirectly through enforcement actions relating to crypto assets – their respective views regarding crypto assets generally, as well as the status of particular crypto assets.[xi] In addition, Gensler[xii] has indicated his view that intermediaries for crypto assets, which may engage in the business of effecting transactions in crypto assets for the account of others or in buying and selling them for their own accounts, are broker-dealers required to be registered. In light of this interest on the part of the SEC, an adviser may wish to consider:

- Enhancing the adviser's procedures for monitoring regulatory pronouncements and developments regarding the status of a particular crypto asset, intermediary, or particular platform;
- Implementing additional follow-up steps to address any regulatory developments, including public statements regarding crypto assets and the regulation thereof, such as reviewing disclosures for potential updates; and
- Reviewing the adviser's processes for seeking representations from an intermediary that it is either a registered broker-dealer or, if it is not registered as a broker-dealer, that it is not required to be registered.

Best Execution

Inherent in an investment adviser's fiduciary duty is the duty to seek best execution of a client's transactions where the adviser has the responsibility to select counterparties and venues through which it executes client trades.[xiii] To meet this obligation, an investment adviser must seek to execute transactions for a client in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances. The SEC has recognized that an investment adviser's best execution obligation is to obtain "the best qualitative execution" and not solely to minimize costs.[xiv]

As such, the investment adviser is required to consider the full range and quality of the services of the counterparty, which may include, depending on the circumstances, the value of research provided by the counterparty, execution capability, commission rate, financial responsibility, responsiveness, and other factors. Investment advisers trading crypto assets on behalf of client accounts should take these factors and other relevant factors into account in determining which counterparties through which they will trade.

"[I]t would be prudent for advisers to consider all crypto assets to be funds or securities for purposes of the Custody Rule . . . [and] to treat all crypto assets (excluding bitcoin) as securities for purposes of their codes of ethics. Advisers may also wish to consider requiring preclearance of transactions in crypto assets and what information should be required in holdings and transaction reports."

Code of Ethics and Personal Trading Policies

Under Rule 204A-1 under the Advisers Act, an investment adviser must establish and enforce a code of ethics that, among other things, requires all of the adviser's "access persons" (*e.g.*, directors, officers, partners, and certain other supervised persons of the adviser) to report their personal securities transactions and holdings in compliance with the rule. The code must also require access persons to obtain the adviser's approval prior to acquiring beneficial ownership of any security in an initial public offering or limited offering.

As noted above, there continues to be uncertainty as to whether crypto assets (other than bitcoin) should be treated as "securities." Nevertheless, in light of the Wahi complaint and Gensler's affirming his belief that most crypto assets are indeed securities, absent any regulatory guidance to the contrary, it would be prudent for advisers to treat all crypto assets (excluding bitcoin) as securities for purposes of their codes of ethics. Advisers may also wish to consider requiring preclearance of transactions in crypto assets and what information should be required in holdings and transaction reports.

Next Steps

While clients are clamoring for access to crypto assets, investment advisers should carefully consider their risks and obligations before choosing to provide investment advice related to crypto assets. In addition to the topics summarized herein, engaging in the crypto asset class presents a number of other considerations for investment advisers, including how to evaluate the risks inherent in new crypto assets, how to determine investor suitability, and what disclosures are necessary to allow investors to be fully informed. As such, before diving in to crypto assets, we recommend carefully considering how this new asset class impacts your compliance and operational obligations.

**Keri Riemer is Of Counsel and Rich F. Kerr is Partner in the Asset Management and Investment Funds group at*

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K&L Gates LLP. Keri may be reached at Keri.Riemer@klgates.com or 212-536-4809, and Rich may be reached at rkerr@klgates.com or 617-261-3166.

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[i] Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n, Kennedy and Crypto (Sept. 8, 2022), https://www.sec.gov/news/speech/gensler-sec-speaks-090822 [*Kennedy and Crypto*].

[ii] Sec. & Exch. Comm'n v. Wahi, No. 2:22-cv-01009 (W.D. Wash. July 21, 2022) [*Wahi Complaint*]. Subsequently, in September 2022, the SEC filed suit against a company and two individuals for conducting an unregistered offering of "securities" in connection with crypto assets. Sec. & Exch. Comm'n v. Chicago Crypto Capital LLC., No. 1:22-cv-04975 (N.D. Ill. filed Sept. 14, 2022).

[iii] Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (Advisers Act) requires each investment adviser registered or required to be registered with the SEC to adopt and implement written policies and procedures reasonably designed to prevent violation by the adviser and its "supervised persons" of the Advisers Act and the rules thereunder. Accordingly, the compliance policies and procedures of an adviser that invests client assets in crypto assets will need to account (although not necessarily explicitly) for such activities. For example, an adviser should consider whether its best execution policies and procedures are consistent with, or sufficiently inclusive for, the adviser's trading of crypto assets.

[iv] The SEC staff has noted that it may be possible for advisers to avoid inadvertent custody in certain situations. For example, to avoid a custody agreement imputing an adviser with custody it did not intend to have, the staff suggested that the adviser could address a letter to the custodian in which the adviser limits its authority to "delivery versus payment," notwithstanding the wording of the custodial agreement, and have the client and custodian provide written consent to such an arrangement. *See* Inadvertent Custody: Advisory Contract Versus Custodial Contract Authority, IM Guidance Update, No. 2017-01 (Feb. 2017) [*IM Guidance Update*].

[v] The chief counsel of the Office of the Comptroller of the Currency indicated that a national bank may provide cryptocurrency custody services, including holding the unique cryptographic keys associated with cryptocurrency, "*provided* the bank can demonstrate, to the satisfaction of its supervisory office, that it has controls in place to conduct the activity in a safe and sound manner." (emphasis not added) *See* Chief Counsel's Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank, SEC Interpretive Letter #1179 (Nov. 18, 2021), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf [*OCC Guidance*].

[vi] *See* Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (Jan. 18, 2018), https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm; Engaging on Non-DVP Custodial Practices and Digital Assets (Mar. 12, 2019), https://www.sec.gov/investment/non-dvp-and-custody-digital-assets-031219-206; and IM Guidance Update.

[vii] *See* Investment Adviser Assoc., No-Action Letter (Feb. 21, 2017). In taking this position, however, the SEC staff stated that it would not recommend enforcement action if an adviser acted pursuant to such an agreement, subject to certain conditions, and did not obtain the surprise examination that would otherwise be required under the Custody Rule.

[viii] Press Release, U.S. Sec. & Exch. Comm'n, Staff Statement on WY Division of Banking's "NAL on Custody of Digital Assets and Qualified Custodian Status" (Nov. 9, 2020), https://www.sec.gov/news/public-statement/statement-im-finhub-wyoming-nal-custody-digital-assets.

[ix] OCC Guidance.

[x] U.S. Sec. & Exch. Comm'n Div. of Examinations, The Division of Examinations' Continued Focus on Digital Asset Securities (Feb. 26, 2021), https://www.sec.gov/files/digital-assets-risk-alert.pdf.

[xi] *See* Wahi complaint and Complaint, Sec. & Exch. Comm'n v. Ripple Labs, Inc., No. 20 Civ. 10832 (S.D.N.Y. filed Dec. 22, 2020), https://www.sec.gov/litigation/complaints/2020/comp-pr2020-338.pdf.

[xii] *See* Kennedy and Crypto.

[xiii] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. IA-5248 (July 12, 2019), https://www.sec.gov/rules/interp/2019/ia-5248.pdf [*Interpretive Release*].

[xiv] *See* Interpretive Release.